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Regulating the regulators

“Competitividad y Marca España”/APIE UIMP

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Good morning.

Thank you very much Miguel Ángel for your presentation and thank you for the invitation. It is a pleasure for me to close this year the course APIE has organised at UIMP. As you know, this isn't the first time I have taken part in the course. I've had the opportunity to do so for several years as Vice-President of the CNMV. But this is the first year, and I hope not the last, I am doing so as Deputy-Governor of the Banco de España.

I shall share with you today some reflections on the situation of and outlook for the Spanish financial sector, which I trust will be of interest to you. I shall focus first on the situation of the Spanish economy, and then review progress on the reform of the banking sector. To conclude, I shall set out some of the challenges facing us ahead, with particular attention to the European Banking Union project.

Macroeconomic environment

As regards the **macroeconomic outlook**, as you all know the Spanish economy is mired in a double-dip recession, largely associated with two different though interlinked factors.

Firstly, the acute contraction in spending, precipitated by the deep-seated real estate market crisis, which has prompted marked job destruction. Secondly, the fragmentation of European financial markets which, despite the recently observed improvements, incorporates a country-risk component which is affecting the availability and cost of funding for the Spanish private sector.

Despite the severity of the current situation, the notable adjustment capacity shown by our economy should be highlighted, as evidenced by the pace at which the imbalances built up during the upturn preceding the crisis are being corrected.

In particular, the **current account balance** has posted a surplus for the first time in over 25 years and forecasts suggest that this positive trajectory will firm in the coming years. Indeed, we expect a surplus of around 4% of GDP for the coming year.

True, these developments are related in part to the contraction in imports, as a result of weak domestic demand; but the improvement in the balance is also attributable to the favourable performance of exports. In fact, Spanish firms are gaining share in international markets, especially in non-EU countries with high growth potential.

As to **price-competitiveness**, the adjustment is also clearly evident. The flexibility gained in the labour market following the recent reform is proving conducive to the adjustment of wages to the economic conditions prevailing. Last year was the first in decades in which compensation per employee fell. This moderation, added to productivity gains, is prompting a sustained decline in relative unit labour costs. Thanks to this, we have already recouped 75% of the losses in competitiveness, relative to the euro area average, that had built up since the start of EMU. We expect the gap to close fully next year.

With regard to **public finances**, there has unquestionably been a rapid and pronounced deterioration since the start of the crisis; however, at the same time, there has been a

notable reaction in the fiscal policy arena. As a result, a structural adjustment of more than six percentage points in three years has been possible. What is involved is an adjustment of an intensity practically unprecedented in the EU.

Unlike in the public sector, **debt ratios** in the private sector, of households and non-financial corporations alike, have been falling. Nonetheless, given the recessionary situation and the low rate of inflation, the bulk of this adjustment has been carried out in the most onerous way, namely through a reduction in credit, which in turn limits the speed of the process.

Banking sector reform

In this macroeconomic setting, our banking system is undergoing unprecedented reform. This involves a far-reaching recapitalisation of vulnerable banks, a rigorous bank balance sheet clean-up and the implementation of ambitious restructuring processes. Reform is following a clear roadmap, with well-defined milestones, set out in the **Memorandum of Understanding (MoU)** agreed in July last year with the European authorities. Allow me briefly to review the work done so far.

Firstly, the most vulnerable banks have been **recapitalised**, covering the capital needs identified in the rigorous stress tests conducted last summer. The capital shortfalls were highly concentrated in certain credit institutions, mainly in those already under the control of the FROB at the time of the tests, while the core of the banking sector – over three-quarters – did not need public assistance. Following this process, all Spanish credit institutions currently meet – and generally quite comfortably so – the requirement for a core capital ratio of 9% of risk-weighted assets.

As you know, the full total of public assistance required by national banks was €39 billion. It should be acknowledged that the volume of support provided by the public coffers was lessened by the burden-sharing exercises carried out by the FROB, following the guidelines laid down in the MoU, and which affected capital instruments, preference shares and subordinated debt.

Allow me to comment on these **hybrid instrument management exercises**.

The exercises are required under European Commission standards for the authorisation of State aid to banks, which have recently been incorporated into our legislation. The principle underpinning them is as follows: insofar as the aim of public assistance is to prevent the insolvency of banks that may affect financial stability, holders of hybrid instruments – who would foreseeably have lost practically their entire investment in the event of a winding-up – need not be bailed out by taxpayers; rather, they shall contribute to keeping the support required from the State as small as possible.

This has also been the experience in other countries. For example, in Ireland haircuts of over 70% were imposed on subordinated debt and, more recently, in the case of a bank under restructuring in the Netherlands, the haircuts entailed the full loss of the investment. The discussions under way on the European Directive on resolution appear to go even beyond this, extending the base of instruments affected.

Spain's case is, admittedly, quite singular in that a substantial portion of holders of hybrid instruments could be considered as retail investors. Accordingly, in our case, the burden-sharing exercises may have particularly marked repercussions on the customer base of the banks concerned. Notwithstanding, the legislation prevents discriminating between investors on the basis of their status. Accordingly, the authorities' task has essentially been to harness all the flexibility available to them under national and European regulations to moderate the impact on retail investors.

This has basically been done through three types of actions in which the Banco de España has been involved: i) first, through negotiations to have the European Commission accept more moderate haircuts than those initially envisaged, in exchange for assuming that the value recoverable by investors should be in the form of shares; ii) second, establishing, through the Deposit Guarantee Fund, a mechanism to give liquidity to the shares delivered in exchange for hybrids in the case of unlisted banks; iii) and third, offering arbitration procedures in FROB-controlled banks that conform to the criteria laid down by a Monitoring Committee set up to that end by a rule with the status of law. These procedures mean that investors harmed by potential mis-selling can be compensated through formulas that are more flexible but formally equivalent to the legal channel.

In addition to recapitalisation, the second pillar of the strategy involved the **clean-up** of credit institutions' **balance sheets**. This objective was mainly achieved through two channels: first, through a considerable increase in provisioning requirements, in particular, for real estate development and construction-related risks; and second, through the transfer of the problem assets of the credit institutions requiring public assistance to an external asset management company (SAREB). As a result of both processes, the net exposure of the banking sector as a whole to the real estate sector fell by more than 50% in 2012.

Finally, I would like to stress that credit institutions that have received public assistance are undergoing a **demanding restructuring process** that entails significant cuts in staff, offices and assets. These measures are essential in order to comply with the rules on public aid and to reduce the excess capacity of our financial system. Moreover, the resolution authority, the FROB, is pursuing a divestment strategy that will further contribute to consolidating the sector. Today, we have sold two nationalised banks, we have promoted two additional corporate operations and we have pushed through the listing of a fifth bank. Currently four banks remain under the control of the FROB. We envisage selling two of these, which are immersed in a resolution plan, in the relatively near future if market conditions allow it.

In short, as the European authorities noted publicly some weeks ago, we are punctually complying with all the commitments entered into in the MoU. Consequently, I believe we can say with a reasonable degree of confidence that the singular problem of the Spanish banking sector – namely excessive exposure to the real estate sector and a lack of sufficient capital at various banks to withstand the far-reaching contraction in the sector – has been successfully tackled.

That said, **several sources of uncertainty** undoubtedly **persist**, mostly related to the macroeconomic environment. In particular, the adverse economic situation, the

deleveraging process and the adjustment of the economy will, inevitably, continue to affect in the immediate future the volume of activity and the profitability of Spanish credit institutions.

To better analyse the impact of the macroeconomic environment, we have recently conducted an exercise to update the stress tests carried out last year by Oliver Wyman, using the latest available information, which includes real data from balance sheets as at December 2012.

The results of this exercise – which were published recently in the Financial Stability Report – show that actual defaults in 2012 for all the loan portfolios were significantly lower than those envisaged under Oliver Wyman's adverse scenario. In fact, the defaults observed are similar to and, in some cases, lower than those estimated under the baseline scenario. Furthermore, the data for 2012 show a better-than-expected profit before provisions, even under the baseline scenario, which suggests that we have begun 2013 in a slightly more comfortable situation than that envisaged in Oliver Wyman's exercise.

We have also performed a forward-looking analysis in order to estimate the expected losses, profits and, ultimately, the capital ratios for the sector in the period 2013-2014, incorporating not only the latest available data but also the most recent macroeconomic projections.

As you are aware, the economic outlook has deteriorated since last summer owing to adverse developments in certain variables such as the unemployment rate and house prices. However, other important variables such as GDP and interest rates are performing relatively in line with and, in some cases, even more favourably than the baseline scenario. The net result is that expected NPLs in the coming months, in accordance with the most up-to-date macroeconomic projections, are slightly higher than those estimated by the consultant under the baseline scenario but continue to be far removed from those under the adverse scenario. These projected developments in NPLs, given the recovery expected in profits, are consistent with estimated solvency ratios at end-2013, standing comfortably above the regulatory limits.

Overall, we can say that these exercises – which we will undertake regularly in the future – offer us some consolation, but we will obviously treat that with all due caution.

Inevitably, our efforts are focused on continuously encouraging and overseeing institutions so that they offer the highest level of transparency possible and maintain the solvency levels required. The most visible initiatives we have adopted in this respect – which are by no means the only ones – are the new transparency requirements on material exposures and refinanced loans, the measures on remuneration of deposits and, more recently, the guidelines for accounting policies on refinanced loans.

Let me share with you, in the last part of my speech, some reflections on the **institutional reform of EMU**, which is essential for addressing the various shortcomings that have become apparent during the crisis.

We are all clear that financial market fragmentation in Europe remains one of the main manifestations of this crisis and the principal impediment to the appropriate functioning of monetary union.

Among the various measures agreed to date to address these imperfections, the Banking Union project is the cornerstone of the programme of reforms.

The first ingredient in the Banking Union project is the creation of the **Single Supervisory Mechanism (SSM)** under the leadership of the ECB. The launch of the SSM, after rapid consensus-building in this respect, is a clear cause for satisfaction. The future importance of the SSM cannot be overstated. In the case of Spain, more than 90% of our financial system will be under the direct responsibility of the SSM, which means that the Spanish banking sector will rank third in importance within the SSM.

As you can imagine, at the Banco de España we are participating intensively in the preparations under way, working in coordination with the ECB and other national supervisors. Accordingly, we are confident that the SSM can begin to operate effectively within scarcely one year. Undoubtedly, this mechanism will contribute to harmonising supervisory practices, to fostering convergence around more stringent standards and to facilitating competition on an equal footing in the euro area's banking market.

In any event, apart from a Single Supervisory Mechanism, a true banking union also requires an effective **Single Resolution Mechanism (SRM)** and possibly also a **Common Deposit Guarantee System**.

The SRM is an essential component for enhancing the perception that the risk associated with the liability instruments of credit institutions does not depend on where they are based in the euro area, which is not so at the moment. Moreover, unified supervision without a common resolution system might cause problems of compatibility of incentives for supervisors and cast doubt on the legitimacy of supervisory actions directed at national citizens.

In my opinion, a well-defined **single resolution mechanism** should have the following characteristics:

First, a common resolution framework with uniform rules which leave minimal room for opt-outs at national level.

Second, a single resolution authority which ensures that the common rules are applied uniformly. Indeed, unambitious solutions based, for example, on a network of national resolution authorities do not seem a workable option for managing a Europe-wide crisis.

Lastly, the creation of a common bank resolution financing system, at least for countries forming part of the SSM, which includes a resolution fund fed by contributions from the European banking industry.

At present it is still uncertain how much progress we will have made in establishing a common resolution system when the SSM starts to operate. I trust that shortly a satisfactory consensus will be reached which will dissipate this uncertainty.

In any event, substantial progress has been made on the future directive on bank recovery and resolution. This directive will radically change the way that financial crises are managed in the future and, in so doing, will change the behaviour patterns of investors and bank customers.

I sincerely hope that the regulatory framework being designed for bank resolution processes will contain a reasonable compromise among four objectives: i) minimising the burden on taxpayers; ii) adequate protection of deposits; iii) affordable financing costs for credit institutions; and iv) rejection of national specificities and opt-outs.

Regarding the other two elements, i.e. the single resolution authority and the common financing system, the European Commission will present a legislative proposal in the next few weeks. The challenge in this case is to find a pragmatic compromise allowing the effective centralised management of resolution processes and the availability of a common back-up mechanism which does not require revision of the current EU Treaties, since this would be a complex process with an uncertain outcome.

To finish up, the Spanish economy is facing a complex economic situation as a consequence of the significant domestic imbalances built up in the boom years preceding the crisis and whose destabilising effect was heightened by the fragmentation of European financial markets.

Domestically, I sincerely think we are taking on an ambitious programme of reforms, both in the economic policy area and in the banking sector. This is allowing a relatively rapid adjustment of the major imbalances of the Spanish economy, which will unquestionably help a sustainable recovery to get under way promptly. Naturally we at the Banco de España insist that there is no room for complacency. Quite the contrary, the challenges facing our economy require us to hold the pace of reform unchanged.

However, an important battle in this war is being fought beyond the Spanish border, at European level. I consider it fundamental that the efforts being made to strengthen EMU and eliminate financial fragmentation should deliver significant results promptly, particularly regarding the creation of a full banking union in the near future.

Thank you.